IN THE

Supreme Court of the United States

OCTOBER TERM, 1931

NO. 582

WOOLFORD REALTY COMPANY, INC., *Petitioner*,

v.

J. T. ROSE, Collector of Internal Revenue for the District of Georgia.

BRIEF OF AMICI CURIAE.

We believe that this is the first case in which the Court has been required to decide what the effect of a "consolidated return of net income" under the Revenue Acts is. In the lower courts, in the Board of Tax Appeals and in the Treasury Department, while there is a tendency toward uniformity in the interpretation of the phrase, on many important questions the decisions and rulings have been inconsistent. This brief is written on behalf of several affiliated groups of corporations, whose tax returns have for many years involved questions about consolidated returns and, among others, the question presented by the case at bar.

THE QUESTION PRESENTED.

Whether in the computation of consolidated net income subject to tax for the year 1927 there may be deducted net losses sustained by a subsidiary company in the years 1925 and 1926, prior to its affiliation with the petitioner, when such subsidiary company, if it were not so affiliated in 1927, would have had no net income for that year.

SUMMARY OF ARGUMENT.

Affiliated corporations filing a consolidated return should be treated as one entity for the purpose of computing the tax.

A statutory net loss deduction should be treated as any other deduction in making up a consolidated return.

The Treasury Department itself, in its regulations applicable to the taxable year 1929 and subsequent years, follows the rule which the Government opposes here.

ARGUMENT.

Affiliated Corporations Filing a Consolidated Return Should Be Treated as One Entity for the Purpose of Computing the Tax.

Consolidated returns of affiliated corporations were first required by an administrative regulation with reference to the excess profits tax (Treasury Department Regulations 41, Arts. 77-78) promulgated by the Treasury Department pursuant to the War Revenue Act of October 3, 1917 (40 Stat. 300). When the bill (H. R. 12863) which was to become the Revenue Act of 1918 was pending before Congress, the Senate Finance Committee deemed it advisable to incorporate therein, and make applicable to both the income and the excess profits tax, the principle of the consolidated return. In its report to the Senate it stated (Sen. Rep. No. 617, 65th Cong., 3rd Sess., pp. 8, 9) as follows:

> "While the Committee is convinced that the consolidated return tends to conserve, not to reduce, the revenue, the Committee recommends its adoption not primarily because it operates to prevent evasion of taxes or because of its effect upon the

> revenue, but because the principle of taxing as a business unit is sound and equitable and convenient both to the taxpayer and to the Government."

The proposed Senate amendment became Section 240 of the Revenue Act of 1918 (40 Stat. 1081). The Treasury Department thereupon promulgated regulations for the filing of consolidated returns of net income (Regulations 45, Arts. 631-638). With various changes in detail, these regulations have continued under the several subsequent Revenue Acts. The underlying principle in each new set of regulations has been stated in almost the same terms. To quote from the regulations in force for the taxable year in question in the case at bar (Regulations 69, Art. 631):

> "Consolidated returns are based upon the principle of levying the tax according to the true net income of a single enterprise, even though the business is operated through more than one corporation."

The courts have used language no less emphatic than that which has just been quoted in describing the effect of a consolidated return. Thus, in *Handy & Harman v. Burnet*, 284 U. S. 136, the Court said, by Mr. Justice Butler (p. 140):

> "The purpose of § 240 was, by means of consolidated returns, to require taxes to be levied according to the true net income and invested capital resulting from and employed in a single business enterprise even though it was conducted by means of more than one corporation."

So also, in *Ice Service Co. v. Commissioner of Internal Revenue*, 30 F. (2d) 230, the Circuit Court of Appeals for the Second Circuit said, by Swan, Circ. J. (p. 231):

> "Congress has declared that two corporations

> shall be treated as one for tax purposes, when one corporation owns or controls substantially all the stock of the other, or when substantially all the stock is owned or controlled by the same interests."

The same theory of the effect of the provision will be found to be set forth in opinions of the courts in all but one of the other Federal Circuits. To avoid unduly cumbering this brief with quotations all to the same purpose, reference is made in a footnote to one case in each of the other circuits, except the First, in which Circuit we are unable to find an applicable case.*

The legislative history of the "consolidated return" provision of the statutes, the repeated administrative interpretation of the provision and the great weight of judicial authority throughout the country bearing upon the matter, all concur in showing that, for the taxable year in which a consolidated return is filed in accordance with the law, the corporations which are parties to it are, for the purpose of determining the amount of their income tax liability, to be treated as a single enterprise.

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*Third Circuit: *National Slag Co. v. Commissioner of Internal Revenue,* 47 F. (2d) 846 (C. C. A.), by Davis, Circ. J., at p. 847.

Fourth Circuit: *Lavenstein Corp. v. Commissioner of Internal Revenue,* 25 F. (2d) 375 (C. C. A.), by Parker, Circ. J., at p. 376.

Fifth Circuit: *Pelican Ice Co. v. Commissioner of Internal Revenue,* 37 F. (2d) 285 (C. C. A.), by Bryan, Circ. J., at p. 286.

Sixth Circuit: *Commissioner of Internal Revenue v. Shillito Realty Co.,* 39 F. (2d) 830 (C. C. A.), by Jones, D. J., at p. 833.

Seventh Circuit: *W. S. Bogle & Co. v. Commissioner of Internal Revenue,* 26 F. (2d) 771 (C. C. A.), by Evans, Circ. J., at p. 772.

Eighth Circuit: *Fidelity National Bank & Trust Co. v. Commissioner of Internal Revenue,* 39 F. (2d) 58 (C. C. A.), by Booth, Circ. J., at p. 61.

Ninth Circuit: *Alameda Investment Co. v. McLaughlin,* 28 F. (2d) 81 (D. C., N. D. Cal.), by Bourquin, D. J., at p. 82; affirmed in *Id. v. Id.,* 33 F. (2d) 120 (C. C. A.).

Tenth Circuit: *Golden Cycle Corp. v. Commissioner of Internal Revenue,* 51 F. (2d) 927 (C. C. A.), by McDermott, Circ. J., at p. 931.

The tax due under a consolidated return (levied on the "consolidated taxable net income" of Art. 635, Regulations 69) is almost always greater or less in amount than the taxes which the constituent companies would have paid, in the aggregate, on a separate return basis. In the calculation of the consolidated net income, two familiar and thoroughly settled incidents, peculiar to the consolidated return, are (1) the elimination of all gain or loss in transactions between the companies participating in the consolidated return and (2) the offsetting of one affiliated company's losses against the gains of another in the same consolidated group. Both of these grow out of the idea that there is but one economic unit—that the tax result should be the same whether the subdivisions of the unit are incorporated or are mere unincorporated branches. The elimination of intercompany gains lessens the tax to be paid; the elimination of intercompany losses increases the tax. Taxes are lessened by offsetting losses of one company against gains made by another; for higher taxes would be due if the companies filing consolidated returns were taxed separately. These differences in amount between the separately computed taxes and the tax computed on a consolidated basis have been regarded as necessary and fair, because, after all, the ultimate ownership of the entire enterprise is the same, no matter whether there is one corporation or more.

In Making Up a Consolidated Return, a Statutory Net Loss Deduction Allowable for 1927 Should Be Treated Like Any Other Deduction Allowable for That Year.

The court below, in the course of its opinion, said:

> *"Of course if appellant is right in its assumption that the statutory net loss deduction must be treated like any other deduction in making up a consolidated return, it is right in its conclusion that it should have had the benefit of it here.* If, on the other hand, as we think, this is a special deduction available only in strict accordance with the terms of the statutes which give it, appellant is wrong and it should have been disallowed." (Italics supplied.)

Section 232 of the Revenue Act of 1926 (44 Stat. 41) provides:

> "In the case of a corporation subject to the tax imposed by section 230 the term 'net income' means the gross income as defined in section 233 less the deductions allowed by sections *234 and 206*, and the net income shall be computed on the same basis as is provided in subdivisions (b) and (d) of section 212 or in section 226." (Italics supplied.)

In calculating this consolidated net income for 1927 under the two sections mentioned in Section 232, above quoted, we note that under Section 234 there are eleven separately numbered paragraphs providing for deductions, such as expenses, interest, taxes, losses, bad debts, depreciation, depletion. At the beginning Section 234 (a) (44 Stat. 41) reads as follows:

> *"In computing the net income* of a corporation subject to the tax imposed by Section 230 *there shall*

be allowed as deductions: * * *." (Italics supplied).

We then apply the second deduction section which Section 232 mentions—Section 206 (b) (44 Stat. 17), which reads as follows:

> "If, for any taxable year, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount thereof *shall be allowed as a deduction in computing the net income of the taxpayer for the succeeding taxable year* * * *." (Italics supplied).

The problem is merely to find, in accordance with Section 232, what is described by the regulations (Regulations 69, Art. 635) as the "consolidated taxable net income" for 1927. Under the regulations with reference to the consolidated return, the Piedmont Savings Company had no "net income" and could have no "net income" other than "the consolidated net income of the affiliated group" (Regulations 69, Art. 632). The question is, therefore, how the "net loss" which that company admittedly had is to affect the "consolidated net income" of the affiliated group.

It is well settled that if the deductions under Section 234 exceed the gross income of any one of the corporations in an affiliated group, the resulting minus balance is nevertheless reflected in computing the consolidated net income. This principle has been followed by the Commissioner in this case, and there has never been any dispute concerning this practice. Likewise, we submit that, if the deductions allowed under Section 206, either alone or when combined with the deductions allowed under Section 234, exceed the gross income of any one of the corporations of the affiliated group, the resulting minus balance must be reflected in the computation

of the consolidated net income. There is no difference between the provision *"in computing net income there shall be allowed as a deduction,"* and the provision *"there shall be allowed as a deduction in computing the net income."* We believe that the court below was clearly wrong in making a distinction in the treatment of deductions under Sections 234 and 206. The same principle of consolidation which properly reduces the tax by offsetting a loss or deficit of one corporation against gains of another which is in the same consolidated group, continues to apply, no matter which of the various authorized "deductions," available for the taxable year in question, accounts for the loss.

The significant facts here are that, after using all the statutory deductions which are allowable in 1927 under Sections 234 and 206, one of the constituent companies shows a loss, that another of the companies shows a gain for the same year, and that 1927 is a year when the corporations in question are allowed to file, and do file, a consolidated return. The fact that some or all of the losses which (under the applicable law) constitute deductions in 1927, came from 1926, or some other year, does not oppose the conclusion that, in the 1927 consolidated return, there shall be the usual offsetting (characteristic of consolidated returns) of the deficit shown by one company against gains shown by other companies of the group.

The Treasury Department Itself, in Its Regulations Applicable to the Taxable Year 1929 and Subsequent Years, Recognizes that a Net Loss Sustained by a Corporation prior to Affiliation Should Be Taken into Consideration in Computing Consolidated Net Income after Affiliation.

No regulation specifically dealing with the state of facts involved in the case at bar was ever promulgated by the Treasury Department until the publication of Regulations 75, Art. 41 (c), approved January 3, 1929. That regulation reads as follows:

> "A net loss sustained by a corporation prior to the date upon which its income is included in the consolidated return of an affiliated group (including any net loss sustained prior to the taxable year 1929) shall be allowed as a deduction in computing the consolidated net income of such group in the same manner, to the same extent, and upon the same conditions as if the consolidated income were the income of such corporation; but in no case in which the affiliated status is created after January 1, 1929, will any such net loss be allowed as a deduction in excess of the cost or the aggregate basis of the stock of such corporation owned by the members of the group."

Under Section 141 (a) of the Revenue Act of 1928 (45 Stat. 831) an affiliated group of corporations have the privilege of making a consolidated return for the taxable year 1929 or any subsequent taxable year only "upon the condition that all the corporations * * * consent to all the regulations under subsection (b) prescribed prior to the making of such return." Under this provision the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, is practically given the power of Congress to lay down the

terms upon which a "consolidated return" for one of the years mentioned may be filed. It is to be observed that the Treasury Department, when it was given this new and wider power, concluded that it would be wrong to deprive the consolidated group of the benefit of any net loss sustained prior to January 1, 1929. In the regulation then promulgated, no limitation whatever was placed on the application of the net loss deduction when the affiliated status was created before January 1, 1929, and even in cases where the affiliated status was created after that date the limitation was no such drastic limitation as that which the Government, without any regulation, argues for here. The Department recognizes that the deduction is the deduction of the affiliated group as a whole, not of one of its members merely; and, in a case where the net loss was incurred, as in the case at bar, prior to January 1, 1929, the Department gives full effect thereto as a deduction from the net income of the group. This result is arrived at under a statutory provision with regard to net losses (Section 117 (b) of the Revenue Act of 1928, 45 Stat. 825) copied verbatim from the provision of the Revenue Act of 1926 involved in the case at bar. Under these circumstances it may well be asked, Why should the Treasury Department litigate in a number of jurisdictions a question which it has itself answered conformably to the position taken by taxpayers? We submit that it should not. But suppose that the Treasury Department, let us say because it is uncertain as to the correctness of the answer which it gave to the question in promulgating its 1929 regulations, is justified in continuing the litigation. Nevertheless, we confidently submit that the court below was wrong. It had no power to prescribe regulations like that given to the Treasury Department as to 1929 and later years by the Revenue Act of 1928. Yet we submit, in view of the

recognition of the correctness of the taxpayer's position by those regulations, and in view of the whole history of the "consolidated return" provision, that the court below really legislated in order to render ineffectual in determining consolidated net income the deduction of a net loss allowable to the taxable entity. Such judicial legislation cannot be justified merely because the net loss was incurred by a corporation prior to affiliation which, as it happened, would have had no net income if it had not been (as it was) a member of a group of corporations filing a consolidated return.

Conclusion.

It is submitted, therefore, that the whole history of net losses of parties to a consolidated return down to the latest regulation on the subject shows that the decisions of the learned court below in this case and in the case of *Planters Cotton Oil Co. v. Hopkins,* 53 F. (2d) 825, and of the Circuit Court of Appeals for the Second Circuit in *Commissioner of Internal Revenue v. Ben Ginsburg Co.,* 54 F. (2d) 238, were wrong and the decision of the Circuit Court of Appeals for the Third Circuit in *National Slag Co. v. Commissioner of Internal Revenue,* 47 F. (2d) 846, was right.

Respectfully submitted,

ROBERT N. MILLER,
JOHN G. BUCHANAN,
Amici Curiae.

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APR 18

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for the District of Georgia

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit

MOTION FOR LEAVE TO FILE MEMORANDUM AS AMICI CURIAE

AND

MEMORANDUM OF AMICI CURIAE

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INDEX

Page

MEMORANDUM BRIEF

I. Under Section 206(b) of the Revenue Act of 1926, the unabsorbed statutory net loss of a company for a prior year, whether or not such company was then affiliated, should be deducted from gross income of the current taxable year, when the company is affiliated with another, to arrive at net income, or net loss, as the case may be 3

II. Prior Decisions Discussed 8

III. All illustration and discussion of cases where the company, having a statutory net loss in a prior year to be deducted from gross income of the current taxable year, was a member of the affiliated group in both taxable years—to show the error of the Department's present practice 9

TABLE OF CASES

Alabama By-Products Corporation, et al., 18 B. T. A. 1919 8
Bowman Hotel Corporation, 24 B. T. A. 1193 8
Buckie Printers' Ink Co., 19 B. T. A. 943 8
Burnet v. *Moore Cotton Mills Co.*, 49 Fed. (2d) 59 ... 6, 9
General Box Corporation, 22 B. T. A. 725 ..... 9, 10
Ben Ginsburg Co., 19 B. T. A. 81 8
Hawley Investment Co., 23 B. T. A. 953 8
National Slag Co. v. *Commissioner*, 47 Fed. (2d) 846 .. 9
Pittsburgh Gasoline Co., 21 B. T. A. 297 9
Swift & Co. v. *United States*, 38 Fed. (2d) 365 ..... 7, 8, 10, 11, 12

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May It Please The Court:

The undersigned, as counsel for The New York, New Haven and Hartford Railroad Company, the Boston & Maine Railroad, the Carnation Milk Company, and The Ohio Oil Company, which have cases in litigation and before the Bureau of Internal Revenue involving questions of carrying forward net losses under the Revenue Acts, similar to the issue presented in the instant case, respectfully move this Honorable Court for leave to file the accompanying memorandum in this case as *amici curiae*.

KINGMAN BREWSTER
JAMES S. Y. IVINS
PERCY W. PHILLIPS

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MEMORANDUM

I.

Under Section 206 (b) of the Revenue Act of 1926, the unabsorbed statutory net loss of a company for a prior year, whether or not such company was then affiliated, should be deducted from gross income of the current taxable year, when the company is affiliated with another, to arrive at net income, or net loss, as the case may be.

The Treasury Department's position regarding the issue in the instant case may be stated by the following quotation from page 5 of the Government's brief:

"Hence an affiliated group may take advantage of net losses suffered by a member before

affiliation only to the extent that the member had net income for the taxable year for which the consolidated return is filed."

The Department in practice applies the same rule even where the member of the affiliated group for the taxable year was also affiliated in the same group for the prior year in which occurred the net loss which is to be carried forward as a deduction in computing net income. The Department's interpretation of the net loss provisions of the Revenue Act of 1926 is erroneous whether the application of the statute be to a situation where the member of the affiliated group (having the net loss to carry forward) was affiliated in the prior year or was not affiliated in such prior year. When applied to a situation where the companies in the group were affiliated in both the year for which the net loss of one of its members was incurred and in the subsequent year to which the net loss is carried, the error in the Department's practice is most patently shown.

Section 232 of the statute defines the term "net income" as meaning the gross income less the deductions allowed by Sections 234 and 206. Section 234 provides for the deduction of certain expenses, losses, bad debts, and allowances in computing the net income of a corporation. Section 206 (b) provides that if for any taxable year it appears that any taxpayer sustained a net loss, the amount thereof shall be allowed as a deduction in computing the net in-

come of the taxpayer for the succeeding taxable year, and if such net loss is in excess of the net income (if any) for such succeeding taxable year, the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year.

The provisions in Section 206 (b) allowing a net loss of a prior year to be carried forward as a deduction in computing net income of the succeeding taxable year is of the same import as the provision in Section 234 of the Act allowing numerous specified items to be deducted in computing the net income of a corporation. The Department permits any member of an affiliated group for a taxable year to deduct from gross income all items allowed by Section 234 of the Act, even when that results in a current net loss. Such loss under the Department's practice is deducted from the net income of other members of the affiliated group in order to arrive at consolidated net income. The other deduction, allowed by Section 206 (b), should equally be permitted in full as a deduction from gross income even if it results in a current net loss for the member of the affiliated group. Such current net loss of the member should be deducted from the income of the other members of the affiliated group in arriving at consolidated net income, exactly as losses resulting from deductions under Section 234 are allowed.

Until all deductions from gross income allowed by the statute have been made, the taxpayer cannot